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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ISSUES OF ACCOUNTING AND REPORTING IDENTIFIED AT THE EIGHTH SESSION

Accounting and reporting during and after the transition from public to private enterprises: an overview

Report of the Secretary-General

SUMMARY

Privatization is a broad concept encompassing the general reassignment of property rights from the State to the individual, contracting out the delivery of public services to the private sector or cutting back in State activities to allow greater room for private initiatives. This report explores the factors influencing the selection of privatization methods, financing techniques and the necessary steps for successful implementation, and it identifies accounting and valuation issues.

* E/C.10/AC.3/1991/1.

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INTRODUCTION

1. One of the areas identified for discussion during the ninth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting was accounting and reporting during and after the transition from public to private enterprises. Privatization is a broad concept encompassing the general reassignment of property rights from the State to the individual, contracting out the delivery of public services to the private sector or cut-backs in State activities to allow greater room for private initiatives. Privatization programmes have been started in a number of countries in the region of the Organisation for Economic Co-operation in Development (OECD), in Africa, Asia and Latin America and recently in Central and Eastern Europe. The privatization process in any country is, essentially, driven by political and economic imperatives which are tempered by national financial and social conditions. Policy objectives include changing and improving the nature of State-industry relationships, such as improving the Government's position, strengthening market forces and competition within the economy, improving enterprise performance, strengthening domestic financial markets and building wider business ownership.

2. Accountants and accounting information generally play an important role in the privatization process. It was the intention of the Group to examine accounting issues which arise during privatization. These include, inter alia, determination of the value of assets and liabilities and appropriate selling price, disclosure rules in prospectuses and financial statements, the transition from government accounting systems to commercial accounting systems and, in the case of Central and Eastern Europe, the transition from accounting for an enterprise in a command economy to accounting for one in a market economy. Before these issues can be addressed, it is necessary to enter a general discussion of the privatization process, namely, the objectives of privatization, the factors which influence the selection of privatization methods, privatization techniques and the steps for successful implementation.

3. Many countries have extensive experience with the privatization process and much relevant information was collected on Argentina, Chile, France, Hungary, India, Kenya, Poland and the United Kingdom of Great Britain and Northern Ireland. However, owing to space limitations, it is not possible to present any case studies in this report.

I. GENERAL DESCRIPTION OF THE PRIVATIZATION PROCESS

A. Factors influencing the selection of privatization methods

4. A privatization process in any country is, essentially, driven by political and economic imperatives as well as financial and social circumstances. Governments expressing similar privatization policy objectives often choose different implementation methods based on their particular national circumstances. These choices then are likely to change as events dictate or permit, as new objectives emerge or priorities shift, and as Governments develop experience with, and awareness of, the various privatization methods that are available.

5. The factors which affect the choice of privatization methods can be generally classified into two groups: those grounded in the motivations for privatization and those linked to particular circumstances. The first group, therefore, includes a number of public policies aimed at changing and improving the nature of State-industry relationships, such as improving the Government's position, strengthening market forces and competition within the economy, improving enterprise performance, strengthening domestic financial markets, and building wider business ownership. The particular circumstances that have to be concurrently considered include the financial condition and performance record of the State-owned enterprise to be privatized, as well as its current organizational form and sector of economic activity, the private sector's investment resources potential, the existence of capital markets, and certain social considerations.

1. Motivation for privatization

Improving the Government's position

6. By adopting a privatization programme, a Government can hope to improve its own financial and operating position in various ways. One main concern is to relieve burdens on the State treasury. These mainly consist of subsidies to the State-owned enterprises, some of which, intentionally or otherwise, may be in a fairly constant deficit position. Also, the State would no longer have to provide loan capital financing to enterprises freeing it for investment elsewhere. Further, proceeds from the sale of State assets can be used to reduce budget deficits.

7. The motivation to reduce budget deficits sparked large-scale privatization efforts in various countries: Canada, Israel and Jamaica, for example. Jamaica's privatization proceeds approximated 5 per cent of annual public expenditure, or 15 per cent of its current deficit (Letwin, 1988, p. 41).

8. Government accounting treatment of privatization proceeds varies from country to country. In the United States, sales of government assets to the private sector may either be recorded as capital revenue or as a loan repayment (Hemming and Mansoor, 1988, p. 16). In the United Kingdom, the Treasury provides that when there is more than a 50 per cent privatization, the proceeds be accounted for as negative public expenditures (Prosser, 1989, p. 109). This means that the Public Sector Borrowing Requirement, which is capped, is thereby reduced and so explains why the United Kingdom has not pursued a policy of partial privatization. In fact, it stepped up its programme when successful privatization showed the potential for sizeable reductions of the Public Center Borrowing Requirement.

9. Breaking down the linkages and community of interests which typically develop between a sponsoring ministry and a State-owned enterprise should help to make the budget resource allocation process more objective. This is because ministries should have considerably reduced incentives to lobby for economic and financial assistance for particular enterprises once their oversight functions are removed. Relaxing management and financing controls over commercial activities allows Governments to concentrate on their main missions of policy-making and implementation.

Strengthening market forces and competition

10. For those, generally few, such enterprises operating in a national or international competitive environment, pressures already exist to increase productive and allocative efficiency. Consequently, for those enterprises, a change-over to private ownership could not be expected to result in efficiency gains of any significant magnitude.

11. The Government can, however, help to strengthen market forces and competition by encouraging the growth of productive private firms through special incentive programmes of investment opportunities and tax advantages. Certain privatization techniques, such as contracting out and franchising, may be particularly helpful for stimulating competitive conditions where there is a natural monopoly.

Improving enterprise performance

12. Strengthening competition and improving economic performance are, of course, two interdependent objectives. Depending on the extent of State ownership relinquished, and whether or not a monopoly is involved, privatization should bring about less direct government involvement, or interference, in company affairs. This will require managers to develop entrepreneurial skills, including attention to the long-run growth of the firm. Relief from the financial constraints of the public sector will be replaced by pressure to compete in the financial markets and to provide investors with satisfactory returns on their capital. So, Governments have to sponsor or support new business education programmes so as to increase the commercial orientation of management personnel.

Strengthening domestic financial markets

13. In countries, such as France, where the usual method of raising capital was through debt financing with banks, privatization through public share offerings was viewed as an important strategy for developing the very weak financial markets so as to attract investment capital. In the United Kingdom, which already had a strong financial market, the potential for expanding private investment was realized by harnessing the goodwill and financial support of the general public to the privatization programme. Because of the very high percentages of employees participating in the special arrangements for share ownership, the concept of encouraging popular capitalism moved to the head of the Government's list of privatization goals (Letwin, 1988, p. 27). The Government of France which drew on British experience in the formulation of its own privatization programme, also included special provisions for share ownership by employees, as well as other French citizens and residents.

Building wider business ownership

14. In practice, the objective of spreading business ownership more widely throughout the economy has been linked to the development of capital markets. The underlying issues driving this objective may be quite varied, for example: concerns about concentration of domestic ownership may lead to a programme of preferential investment opportunities for particular population groups, as in

Malaysia; on the other hand, concerns about concentration of foreign ownership may lead to limitations being placed on foreign direct investment through joint venture participation or interest in public share offerings. In the United Kingdom, the building up of wider business ownership over the past decade reflected the general philosophical view of the governing party that, to the fullest extent possible, economic activities should be left to the private sector. In Poland, widespread privatization is viewed as a vital strategy for shifting as fast as possible from a command to a market economy.

2. Financial and social conditions

15. While public policies which weave together political and social interests in the light of the economic situation may forge a privatization programme, other considerations linked to particular circumstances or infrastructural characteristics may also affect the choice of privatization mechanisms.

Enterprise financial profile

16. An enterprise should have an attractive earnings history, or potential, if a change of ownership is contemplated. Otherwise, it will have to be readied for the market by restructuring its sources of funds or by overhauling its operations. The United Kingdom was willing to spend, in some cases, several years building up its potential candidates. France, on the other hand, pursued a relatively fast pace although restructuring was also employed in the case of three loss-incurring groups: Compagnie générale de constructions téléphoniques, Crédit commercial de France, Crédit du nord: a Paribas subsidiary (Vuylsteke, 1988, p. 60).

Organizational form

17. The current organizational structure of the entity to be privatized, and the complications of legal reorganization, as well as the time period involved, have a strong bearing on the approach to use in privatizing. In the case of a government department, the path to divestiture has three stages: commercialization, corporatization, and divestiture (Andersson et al), that is: the government department is first converted into a self-accounting entity, then into a State-owned corporation, then into a private sector company. This is the process currently being followed in France where the Government is divesting itself of its telecommunications services; a process extremely complicated by two circumstances. The financial transactions were mingled with those of the postal services in one joint activity: and governmental, rather than commercial, accounting was used. Organizational and accounting problems are considerably reduced in cases where companies being privatized legally exist as corporations.

Sector of economic activity

18. When very large State-owned enterprises, such as public utilities, enjoy monopoly or near monopoly status, they provide the greatest possibilities for productive efficiency gains from at least three contributing factors (Hemming and Mansoor, pp. 12-13): reduced political interference; changes in the structure of

property rights, such as the existence of a shareholding group that motivates efficiency in managers; and competition in the capital markets. However, an effective regulatory system to safeguard consumer interests, with minimum potential adverse effects on productive efficiency opportunities, may be difficult to design. In the United Kingdom, three basic regulatory measures accompanied the privatization of British Telecom and British Gas Corporation (Vuylsteke, 1988, p. 63). These consisted of granting operating licences with certain provisions aimed at guaranteeing the continuity and quality, as well as the pricing, of services; establishing a regulatory body and introducing measures to start reducing or removing monopoly rights. In modern times, that is, over the past century or so, France has made heavy use of management contracts as well as the "concession" and "affermage" farming out or leasing arrangements. That is, a private operator provides a particular service very frequently water distribution, to the public, bearing all the financial risk and returning an agreed-upon revenue to the owner, a government entity, which retains control.

Availability of local capital

19. If very little investment capital is available from the private sector, as is the case in Eastern Europe, and government policy is to minimize reliance on foreign participation, some techniques will need to be tailored to particular situations. These could include the general distribution to citizens and/or residents of free coupons with specified privileges as to privatization acquisitions, as well as liberal financing plans.

Existence of capital markets

20. The privatization technique of public share offerings generally presupposes the existence of capital markets, distribution channels, and an investing public. While the last two elements seem indispensable, public share offerings can still take place as Poland recently demonstrated with its first five large-scale transfers of ownership. All that is needed is an adequate substitute mechanism, such as the banking system as in Poland and Kenya.

Socio-political considerations

21. Apart from such possible financial constraints as weak capital markets and lack of domestic investment interest or capacity, Governments may have to face such political constraints as ideological opposition, reservations as to the strategic importance of privatization candidates, and concerns voiced by groups such as trade unions and the media which have vested interests in the status quo. Other opponents could include bureaucrats who had benefited in various ways from their oversight relationship, and an enterprise's management and workforce contemplating unemployment, curtailing of privileges, and the uncertainty of performing in a new environment. Because State-owned enterprises are often used as vehicles for achieving various social objectives in addition to their main functions, the general public may express wider concerns about the possible social and economic consequences of privatization.

22. As just one example, the maintenance, or creation, of employment which public ownership can provide is viewed by many as a social benefit as well as a way of minimizing other social costs particularly unemployment benefits. Further, the closing down of government facilities, or the scaling back of government employment, particularly in smaller communities, has a multiplier effect. In selecting among implementation alternatives, Governments would be interested in minimizing the potential adverse effects. If unemployment is a main concern, for example, certain guarantees might be contemplated in contracts for private sales, as well as the possibility of selling or leasing enterprise assets to enterprise employees, as provided for in Poland.

B. Review of privatization techniques*

23. If the definition of "privatization" goes beyond the transfer of public ownership to the private sector to encompass a more general concept of introducing market forces into an economy (Vuylsteke, 1988, p. 1) or strengthening those that already exist, then privatization has taken three main forms across the world: contracting-out of government services, deregulation of monopolies or near monopolies, and trade sales, that is, sales of public assets.

Contracting-out

24. In major industrial countries, contracting-out has become the most popular method of providing such local government services as garbage collection, street cleaning, catering for the elderly and government office cleaning. In the United States, urban public transport and various prison operations are notable additions to this list. One of the main reasons for this choice of technique, rather than, say, selling franchises, is the fact that most of these services are usually supplied free of charge. Consequently, a would-be franchiser or purchaser would only be able to collect fees from the governmental authorities, not from the general public.

25. In addition to local services, considerably larger activities have been let out on contract. These include the operation of plants and mills in Cameroon, wells and irrigation projects in Pakistan, and hotels in Sierra Leone, Tunisia and the Caribbean countries. On a larger scale, the United Kingdom has used this approach to contract for major construction projects, as also have Turkey and Australia, among others.

Deregulation

26. Deregulation is a process of both removing obstacles which prevent private sector companies from competing with State-owned monopoly enterprises as well as designing a new regulatory environment to protect the consumer while encouraging a competitive environment. In Japan, for example, the Nippon Telephone and Telegraph

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* This section is based mainly on Letwin (1988) and Vuylsteke (1988).

Company's monopoly was removed in 1985 and the Government also opened new services to competition such as leased lines and value-added information services. In the same year, Canada initiated measures to deregulate transportation services: with respect to the airline industry, additional routes were planned for private sector airlines, thus providing competition with the dominant carrier, Air Canada. In 1986, Spain announced that it was preparing legislation to rescind the television monopoly, provide for three independent channels, establish an independent regulatory body, and ensure renewable contracts and transmission access for private competitors.

Trade sales

27. Trade sales have been widely used to privatize relatively small or medium-sized State-owned enterprises, usually in poor financial condition; to downsize an enterprise by disposing of certain segregable parts, such as individual assets or groups of assets, such as plants or units; or to dispose of assets, with or without liabilities, after a company has been wound up that could not be sold as a going concern. These sales are attractive to investors for several reasons. One advantage is that the Government's decision to use a trade sale implies that the sales price should be within the financial capacity of an individual buyer or consortium. Another is that the investor has the opportunity to profit by financial restructuring to turn the performance of the enterprise around, if need be, as well as exploiting the potential synergies of combined operations.

28. In the United Kingdom, sales of council houses (that is, homes owned by local authorities) to their tenants sparked the Government's privatization programme. It proved to be extremely successful amounting to 1 million such sales (Letwin, p. 90) and paving the way for public interest in share offerings participation. Trade sales were also employed to privatize two defense-related enterprises: Royal Ordinance Factories and Short Brothers. In the case of the French Compagnie générale d'électricité, the company was dissolved so that it could be split up, and sale of assets followed.

29. When Alfa Romeo was sold by the Institute for Industrial Reconstruction to Fiat, tax advantages to the Institute of Alfa Romeo's operating losses underlay the design of the sale arrangements. Alfa Romeo sold its assets, and with its liabilities transferred to a company organized by Fiat-Lancia, remained a shell whose losses could be written off against profits of other companies in the Institute's group.

30. In other instances, Governments have not required buyers to take over liabilities. In Guinea, for example, government-owned assets, free of liabilities, were sold to private buyers in order to stimulate the growth of private companies. Guinea's selection procedure followed that used in France of requiring bidders to submit their plans for future operations, using the assets.

31. Sales contracts may be awarded by either auction or by a competitive bidding process. Because of public sensitivities about perceived "bargain prices", it is essential that the award procedures provide for transparency and impartiality among

bidders and fairness and objectivity with respect to prices. To this end, the French award procedures include oversight by an independent privatization commission.

32. Although the above techniques of contracting-out, deregulation and trade sales are the most widely used, they suffer from the disadvantage of smallness of scale. Where very large enterprises are involved, the value of the assets to be transferred to the private sector usually calls for the existence of strong capital markets and the use of share offerings. As a bridging technique, the British privatization programme adopted the private sector approach of management-employee buyouts, a concept also used in France, Italy, Chile and elsewhere, including, more recently Hungary and Poland.

Management-employee buyouts

33. A management-employee buy-out is a technique whereby the managers and employees acquire a controlling interest in a company. If they have to obtain financing in connection with the purchase, it is referred to as a leveraged buy-out and the company's assets are used as security for the loans. The usual procedure is for a holding company to be created in which the management and employees buy a controlling interest. The holding company then uses the equity and any debt funds to buy the privatizing enterprise, subsequently paying debt interest and principal out of the funds available from enterprise dividends. In Poland's first large-scale privatization in the fall of 1990, the management-employee buy-out of the State-owned Inowroclaw Packing Plant was carried out, technically, without the holding company feature. The enterprise was transformed legally from a State-owned corporation to a limited liability company with the State as sole shareholder. The State then sold the shares to the workforce.

34. Buy-outs by the workforce are potentially very risky for the business because of the usual lack of entrepreneurial experience on the part of the workforce, coupled with the probability that the company may have been experiencing operating and financial difficulties. The employees themselves may have gone into debt to buy their shares which was the case in Inowroclaw. As part of the British Government's programme of building up public support for privatization, management-employee consortia were granted special privileges. These included accepting buy-out bids from the workforce even though, in the case of British Shipbuilders' warship yards, it was not the highest submitted (or other bidders might have been considered safer). Another incentive was a free share scheme for share purchases over a certain minimum amount.

35. In contrast to potential risk, the workforce buy-out approach offers certain advantages. First, it minimizes the social costs associated with lay-offs and liquidation of the enterprise if this was the alternative. Secondly, it should have a beneficial effect on future productivity. In the United Kingdom, which made comparatively heavy use of this technique, it played a significant role in achieving a major privatization objective of increasing popular capitalism.

Joint ventures

36. In addition to management-employee buy-outs, another bridging technique to larger-scale privatization is the joint venture, a hybrid approach which reflects elements of other methods, including trade sales and management contracts. For some countries, such as Hungary, it has been viewed as one of the most immediate methods of attracting foreign direct investment. Through this means a country's need for outside capital, technology transfer and operational "know-how", and the building-up of the infrastructure can be brought together with the investors' interest in business expansion and profitability.

37. Joint venture agreements can take various legal forms, ranging from simple trade agreements to jointly owned companies. In the Czech and Slovak Federal Republic, joint ventures may, under Law 173/1988, take the form of joint stock companies or associations (Kosina and Dolezal, p. 44). In Yugoslavia there are four options: public limited company and/or joint stock company; private limited company and/or limited liability company (privately held); limited partnership, or partnership (Petrovic and Turk, 1990, p. 60). Not only does joint venture legislation vary between countries, reflecting national policies, but legislative changes occur within a country, particularly in the Union of Soviet Socialist Republics and Eastern Europe, as experience is gained in joint venture operations and national priorities shift.

38. Environmental conditions can have a significant impact on the types of activities carried out by joint ventures. Large-scale, long-term investment is easier to attract where there is stability in the political, legal and financial systems. Where this stability is lacking, joint ventures are likely to be concentrated in services, rather than production, where the risk of loss is minimized and pay-back periods very short. As a result, the choice of geographical location of a joint venture, assuming the same partners, constitutes a critical decision (Hübner and Gruhle 1990, pp. 76-80).

Share offerings

39. A public share offering, used most frequently when large amounts of capital need to be raised, and widespread ownership is a major objective, is the technique which generally creates the most public awareness of the privatization process. It is also the most technically difficult approach, requiring considerable care in choosing the candidate State-owned enterprise and carefully planning the details of the flotation.

40. To be successful, a public offer usually requires a well developed financial market, although other arrangements can be substituted, such as an attractive investment opportunity, that is, a company in good financial condition with the potential for maintaining profitability. Otherwise, restructuring will be needed to ready the firm for the market. The enterprise will also have to be legally reorganized as a public limited company with the State as sole shareholder. Shares may be offered at a fixed price, or bids may be invited. In some countries with a strong financial community, such as France and the United Kingdom, issues may be underwritten.

41. A partial privatization results when the State decides to hold back some of the shares. This may either be intentional, such as the planned implementation of privatization in stages, or because the number of shares offered is based on best estimates of what the market can take. An example of a two-stage process, which is one of the features of the French privatization programme, is an initial direct sale of shares to a hard core (noyau dur) of investors so as to provide a stable shareholder group in connection with a related public offering.

42. Private placement would be the preferred approach if the candidate enterprise has a poor financial profile but favourable prospects for operational turn around by buyers with the appropriate experience and financial strength. This method is less appealing politically than a public offering because of the relatively closed nature of the process which can give rise to concerns about possible preferential treatment. Consequently, mandatory prescriptions or detailed guidelines governing the various aspects of a private sale have been introduced in France and elsewhere to control for fairness. Despite its detailed competitive bidding procedures, however, the French Government has faced heavy criticism over perceived conflicts of interest.

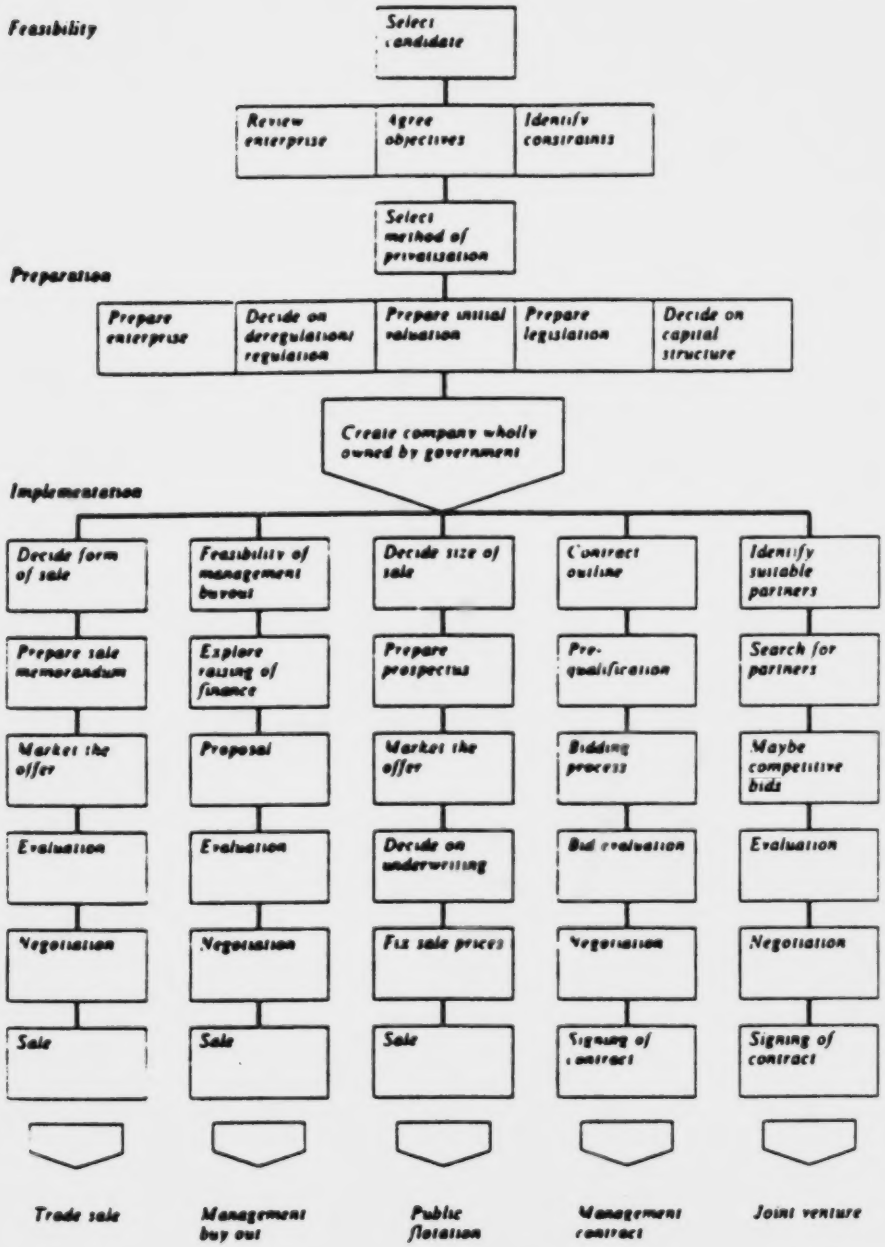
43. Although by 1987 only eight major Governments had used public offerings, the majority of their State-owned assets, amounting to some $50 billion, were privatized in this way and over 25 million investors, including a million employees, were involved (Letwin, 1988, p. 106). To be successful, these large-scale programmes required considerable advance planning and careful management, which is the central theme of the next section.

C. Steps for successful implementation

44. Before launching a privatization programme, an overall master plan should be drawn up that is congruent with the Government's long-run political, economic and social goals. Action plans are then developed from the master plan, taking into consideration the implications for resources as well as investment and consumption outlays. At the third level is the plan for privatizing a particular State-owned enterprise or group of them.

45. As a general model, the planning and management of an individual privatization involves three stages: feasibility assessment, preparation, and implementation, as set out in table 1. In the initial stage the candidate enterprise is chosen and the method is selected. In the intermediate, preparatory, stage the candidate State-owned enterprise is made ready, legislation is prepared, initial valuations are made, and certain key decisions are arrived at, such as appropriate capital structure and, for those enterprises operating under monopoly conditions, deregulation processes. Once the privatization process gets under way in the implementation stage, various other, and often interrelated, activities take place so that there is a critical need for attention to the timing and sequencing of events. This is where timetables, such as those used in the United Kingdom and France, can prove to be invaluable. While timetables may not be adhered to exactly, they provide essential frameworks for coordinating efforts and setting deadlines.

Table 1. The privatization implementation process



Source: Coopers & Lybrand Deloitte, "Implementing privatisation", OECD East-West Accounting Issues Conference, Paris, 25-27 September 1990, p. 3.

46. The length and complications of the preparatory stage will depend, of course, on the circumstances of a particular privatization. Not to be overlooked in all cases as a critical element, however, is the degree of enthusiasm with which certain key players carry out their tasks. In France, for example, several chief executive officers of privatization candidates were shuffled around between different posts to minimize potential motivational problems (Letwin, 1988, p. 95). The United Kingdom, on the other hand, followed the quite opposite strategy of minimizing personnel changes among senior managers. Information programmes for public officials, trade unions, management, and employees, among others, can clarify concerns and help to promote interest and cooperation. These should be instituted at the earliest opportunities when rumours and uncertainties are rife. Their purpose and content, then, are different from those of the publicity campaigns carried out in the privatization implementation stage.

Feasibility assessment

47. Choosing the appropriate candidate enterprise is the most important, and typically the most difficult, first major decision particularly if this is to be the first privatization in the programme. To provide a favourable climate for subsequent transfers of ownership, the first candidate should be as attractive as possible. After one or more suitable candidates have been identified, an assessment is made of the probability of a successful outcome in each case, in the light of the Government's overall and specific objectives, and any particular advantages or constraints. These would include the general business climate, the section of the market affected, the level of potential investor interest, the availability of financial resources, and the financial and operating profiles of the candidates. This assessment should lead to two outcomes: the final selection of the privatizing candidate and the most appropriate privatizing technique to be employed.

Preparation stage

48. Once the candidate has been chosen, it has to be made ready for ownership transfer. This may require specific legislation, or the transfer may be accomplished under the umbrella of a general privatization law. Further required legalities will depend on the privatization method to be followed and the market environment affected. If, for example, a State enterprise, or a segregable part of it, is to be transferred as a going concern, its legal transformation to a public company under the commercial code will be required. If there are monopoly characteristics inherent in the market for the privatizing enterprise's goods or services, a new regulatory framework needs to be put in place, and an oversight body empowered to protect consumer interests while at the same time minimizing possible regulatory threats to enterprise efficiency.

49. Interrelated decisions also have to be arrived at concerning the enterprise's capital structure and its initial valuation. Necessary structural changes will have to be introduced if the enterprise is to be fully or partially privatized through split-offs, or other forms of fragmentation, as provided for in Hungary and Poland, for example. If the enterprise's potential sales value could be enhanced through strengthening of its financial position, restructuring would be needed.

This could involve refinancing debt, reorganizing operations to reduce or eliminate unprofitable activities, slimming down the payroll, or bringing in new management. The entity's capital structure will have to be evaluated. If it is to be operated in a competitive environment, there will be investor interest in capital flexibility and liquidity particularly by private placement buyers. This will put pressure on the Government to decrease debt to equity ratios, and minimize the amount of enterprise liabilities to be assumed by the buyers. Significant problems may be encountered with respect to unrecorded obligations such as unfunded pension liabilities. These and other accounting problems are the subject of the next section. Various sets of conflicting interests may have to be resolved often related to the enterprise workforce. These include minimizing layoffs, equitable treatment of redundant workers, and the seniority status of those retained by the new employer.

50. The remaining major activity carried out in the preparatory stage is an initial evaluation. Two key determinants of valuation, already mentioned, are the potential market response and the enterprise's history of profitability (to be discussed in the following section). Analysis of the potential market response encompasses not only volume of demand but its sources. Government policies with respect to potential buyers will need to be reviewed, as well as terms of sale. Is there, for example, to be encouragement or discouragement of foreign holdings, employee participation, discounts or other incentives to particular buying interests, free distributions, and deferred payment arrangements? Setting a fair price that is within the range of the targeted buyers will be challenging if the enterprise's profit history is poor or weak because prices are linked to potential earnings capacity. If restructuring to improve the financial profile is not an option, a viable alternative to a fixed price offer is to let the market set the price through competitive bidding or auctions both in public offerings and private placements. Competitive bidding would not be a preferred approach if a primary objective is to encourage widespread public participation because of its relative ambiguity and complications. A modification would be to sell an initial block of shares on a bidding basis, and then follow with a fixed price offer. This was the method used in selling Nippon Telephone and Telegraph (Vuylsteke, 1988, p. 113) but for a different underlying reason: an initial fixed price was difficult to establish because of the uniqueness of operations. To protect the Government's interests, a floor price could be set before offers are solicited.

51. An additional aspect of market interest is consideration of buyer motivation, particularly in the light of the particular market involved, as well as general business conditions. Higher prices can be commanded if buyers perceive opportunities for improving enterprise efficiency, as well as achieving certain market dominance with a minimum of regulatory interference. If the business environment is unstable, buyers will prefer those options, such as joint ventures engaged in service activities, where capital outlays can be minimized and pay-back periods are relatively short. Consequently, buyer interest have to be stimulated through special fiscal and financial concessions such as tax holidays, lower interest rates and so forth. It is therefore critical that government fiscal policies and privatization policies be coordinated through the master plan mentioned earlier. In France, for example, fiscal and privatization policies were coordinated in one ministry: the Ministry for the Economy, Finance and

Privatization. In Poland, on the other hand, fiscal policies are set in the Ministry of Finance while the Minister for Ownership Transformations is responsible for privatization decisions. A multiplicity of governmental interests, not necessarily congruent, can have adverse consequences for the privatization process. After the Inowroclaw Packing plant privatization in the fall of 1990, effected as a management-employee buy-out, the fact that the enterprise did not receive anticipated fiscal concessions led to Poland's large-scale privatization programme receiving very poor press publicity in its early stages over the Inowroclaw affair. To sum up at this point, the Government's particular or general privatization policies should drive the various preparatory activities which set the stage and give the momentum to the implementation process.

The implementing stage

52. It is in the implementation stage that a PERT (Program Evaluation and Review Technique)-type of calendar of events, such as that designed in France, can prove most valuable for the essential coordination of people, activities and events so that the process may unfold in logical and timely progression. Drawing up such a document can, by itself, help to cut down on misunderstandings and confusion that necessarily arise when a complicated task is undertaken. It also acts as an essential management control tool, by matching resource inputs and performance outputs over the allowed and available time period. Even though each privatization may be unique, there are certain similarities among disparate techniques, as table 1 shows. Deciding on the form, or size, of the ownership transfer, seeking and identifying buyers, exploring financing capacity, marketing the offer, evaluating responses, negotiating or otherwise arriving at agreements and finalizing the transaction.

II. ACCOUNTING AND VALUATION ISSUES

53. Because the term "value" means different things to different people, in much the same way as "truth" and "beauty" for example, it is not surprising that there is room for considerable subjectivity in value measurement as well as controversy over value determination. So, it is particularly important that parties involved in a transfer of ownership understand at the outset what it is that they are trying to accomplish, not only because of the inherently contentious nature of the exercise but also because measurement approaches differ depending on the circumstances. Another aspect in the valuation problem, is the fact that there are widespread misconceptions about the usefulness and relevance of accounting information for valuation purposes.

54. Accountancy's main function is to record and report on past events. The valuation process, on the other hand, is concerned about the acquisition's utility, in monetary terms, for the buyer in the future. So, accounting information about prior transactions which has been accumulated in the past by the seller will only be relevant for decision-making purposes if it has some bearing on anticipated future events. This means that book values may play only a minor role, if any, when parties agree on a price. However, because of the publicity given to book values during privatization processes, and the importance attached to them by the

electorate, it is politically difficult for some Governments to set prices below book values because of concerns that the national inheritance is being disposed of too cheaply.

A. Valuation approaches

55. Although valuation methods are many and varied, certain approaches have become standard ways of estimating values under particular circumstances. The most commonly encountered, which may be applied individually or in combination, are: liquidation value, replacement value, book value, present value and the price/earnings ratio. In describing them, the item being valued will be referred to, for convenience, as a business interest.

Liquidation value

56. Liquidation value, also referred to as net realizable value, is a seller-oriented estimate of the amount that could be raised by a sale, net of any disposal cost. If the business interest is an asset, disposal costs would include shipping and handling, commissions, and so forth. If it were a business or business segment, the disposal costs would be expanded to include those connected with selling the inventory, collecting receivables, terminating employees, and all other winding down activities. Opportunity costs should also be taken into account, particularly depending on the length of time required or available to carry out a liquidation. While sale prices could be higher if time permitted a longer search for buyers, returns to the Government from other sources would be lower as production wound down during the buyer search period. When the Polish Government was considering liquidating the S. Struga Woollen Industry Plant in Lodz, for example, the accounting and opportunity costs of delayed liquidation were estimated at 96.2 billion zlotys (over $US 10 billion) when considering also the loss of various tax collections and payment of unemployment compensation to one half of the workforce. As a result, Struga received subsidies to keep it operating and thereby decrease potential losses to the State treasury.

57. Liquidation value should represent the lowest estimate of what a business interest is worth. In the accounting system of developed market countries, this value, expressed as net realizable value, expresses the concept of prudence, or conservatism, in the balance sheet presentations of inventories and accounts receivable.

Replacement value

58. Replacement value is a buyer-oriented estimate of how much it would cost to replace the business interest in its current condition and is an approach which is generally followed for insurance purposes. Generally speaking, replacement values are higher than liquidation values if for no other reason than the fact that there are no disposal costs to deduct from realizable amounts.

Book value

59. Book value, as mentioned earlier, is the value of the business interest as reflected by its accounting records. For an entire business, book value would equal total assets minus total liabilities, that is, the net equity. There are several reasons why a company's book value, as shown on its balance sheet, would not necessarily give an adequate picture of the financial position as of a certain point in time; the basic problem being that in most countries, accounting follows the historical cost principle. Under this principle, transactions are not recorded until they have occurred and can be expressed in monetary terms. Once recorded, asset amounts may be decreased for unrealized losses, but not increased for either unrealized gains or inflationary effects. A company may, for example, have considerable hidden wealth in the form of fixed assets whose replacement costs are significantly higher than book values because periodic revaluations are not permitted by the accounting standard-setting body. Certain intangible assets, such as goodwill, may not be recorded in the accounts unless purchased and certain liabilities of potentially very large proportions, such as unrecorded pension obligations and liabilities for environmental protection measures, may be of a contingent nature requiring notification in the company's financial statements but not recording in its accounts. So, when readying a company for privatization and reviewing its capital structure, it is critically important to search for any unrecorded assets and liabilities.

Present value

60. For most, if not all, business acquisitions the purpose of the valuation exercise is to arrive at an estimate of the present value of the business interest's earning power. That is, to calculate the value of future benefits and, with the use of an appropriate interest rate, discount them back to their value today. In theory, this approach requires an earnings forecast which will, of course, be based on various assumptions about future economic conditions as well as business expectations. Not only are such projections difficult to construct but they are also difficult to justify when contracting parties have different sets of future expectations. Consequently, various approaches have been developed that use historical data as proxies for projected data or, alternatively, use both and vary the weighing assigned to particular assumptions. Whichever type of data is used, certain key variables have to be taken into consideration, depending on the circumstances. These include: earnings, cash flow, dividends, assets, and revenues, and all are sources of value to potential investors.

61. If projected future earnings are an important element of the valuation process, it is imperative that the parties agree on how they are to be defined and measured. If prior period earnings form part of the projection base, they need to be analysed to make sure they meet the ground rules for definition and measurement and that they do not need to be adjusted for any unusual and non-recurring items that could distort the projections. As pointed out below, the definition of revenues is also extremely important in this context.

62. In some situations, net cash flows may better reflect value than net accounting earnings. This is particularly true in the case of well-maintained, improved real estate because, as a rule, such property tends to maintain its market

value. Consequently, charges for depreciation against income, which is an accounting convention applied to capital outlays, diminish net accounting earnings but have no effect on the market value of the real estate improvements. Because there has been a considerable amount of privatization of improved real estate in Hungary and Poland, and now in Czechoslovakia, this is an important point to consider.

63. To investors, the two chief sources of value from shares in a company are the stream of periodic dividends and the possible gain on resale of the shares in the future. Where the transfer of share ownership may be difficult because of the undeveloped nature of capital markets, more investor attention is concentrated on dividend paying ability. Consequently, considerable weight would be placed on the discounted stream of potential dividends as a measure of share value. As a general rule, dividends should only be paid out of earnings, and earnings should also be the main source of a company's financing. In countries, where the board of directors has responsibility for dividend declarations, the directors can be expected to give considerable attention to the internal financing and investment needs of the company before deciding on the amount of the periodic dividend. In countries, where the commercial law provides that the shareholders declare the dividends, usually at the annual shareholders' meeting, one may expect the decision process to be reversed. Consequently, one has to be alert for "hidden reserves", that is, understatement of earnings through conservative accounting practices, or funnelling of earnings through reserve accounts, in order to show minimum net earnings available for dividend declarations. So, in relating dividends streams to enterprise value, attention has to be given to the matter of where dividend declaration control lies.

64. Gross revenues may appear to be the most appropriate source of value estimates, particularly in services or where the earnings record has been poor and buyers could expect to improve profitability. Two very important aspects of the valuation process will be how the revenues are defined and measured and what are their primary sources. Revenues measured on a cash basis, may vary in timing and amount from revenues measured on an accrual basis. Further, business interests with diversified clients would have a lower risk assessment than those where revenues were heavily concentrated in fewer clients.

65. Additional factors which come into play include the quality of the business interest's management, its products, the industry it is in, the markets and strength of demand for its output and its research and development policies and performance. A considerable amount of this type of information may be found in a public offering prospectus and, while extremely helpful for a professional investor, tends to add to an information overload situation for an unsophisticated public. This was a major complaint raised in the Polish press when the first five major State-owned enterprises were privatized through public share offerings.

66. Interwoven through all of the valuer's assessments will be the risk factor. Basically, the level of risk is measured by the perceived degree of certainty that future expectations will be realized. Investors examining alternative available business interests with comparable risk levels will set an expected rate of return that would make this set of business interests attractive as investments. This

expected rate of return is known as the cost of capital. It is set by the market so it is largely outside of the control of an individual company, and it constitutes one of the most important elements in business valuation because it is used as the discount rate. So, the higher the perceived level of risk, the lower the calculated present value. Government intending to privatize a business interest and wishing to maximize its estimated value should, therefore, try to reduce the cost of capital by attempting to lower the perceived degree of risk involved.

67. Apart from the discount rate, the other important remaining element in making valuation calculations is the time period to be used. These are, of course, interwoven considerations because there is usually a correlation between the level of risk and the length of the time period under consideration. That is, the longer the time projection into the future, the higher the level of perceived risk.

Price/earnings ratio

68. The price/earnings ratio is a very widely used stock market indicator of business value and can be extremely helpful in guiding the pricing of new public offerings. For long-established companies that have reached a steady level of earnings, this multiple is likely to be relatively low - in the five to seven range. For relatively new companies with favourable expectations of significant increases in future earnings, multiples can be very high. As the company matures, the price/earnings ratio should start to fall but, in the meantime, an early buyer of shares has the significant hope of realizing capital gains on the sale of the shares. Governments which privatize through public offerings can make initial share prices attractive through low price/earnings ratios. This was very apparent in Poland's first such privatization when some of the company shares were offered at price/earnings ratios less than one to one. This approach to valuation represents a resort to the use of historical accounting information, for determination of the earnings figure, when there are difficulties with making projections for the discounted future earnings or discounted future cash flows approaches that would yield meaningful or reliable estimates of present value.

B. Accounting-related issues

69. Accounting-related issues may be roughly grouped into various sets of circumstances which have differing degrees and types of implications for the accounting and reporting functions and the accounting and auditing professions. These circumstances include, but are not restricted to, existing congruency between accounting for public sector and private sector enterprises, the effects of changes in the legal structure to be privatized, and the effects of changes in a country's economic structure.

Accountancy congruency

70. The first concern has to do with the degree of congruency which exists between the accounting, auditing, and reporting requirements for State-owned versus private sector enterprises. In some developed market economies, such as the United Kingdom and France, the degree of congruency is very high. The British nationalized industries, for example, have to follow commercial accounting practices, their

accounts are audited by independent chartered accountants, and their annual reports are published in commercial format. In France, the chart of accounts (plan comptable) was originally mandatory only for State enterprises but its use was gradually extended to the private sector. When the French State enterprises were permitted to issue securities publicly, they had to conform to the disclosure requirements of the stock markets. So, increasing the degree of congruency between accounting, reporting, and auditing requirements for State-owned and private companies would be an important first step in minimizing the accounting implications of a privatization programme.

71. For countries switching to a market economy, however, this first step involves massive efforts to rewrite a series of laws affecting the accounting and reporting functions and the accounting and auditing professions. A chief difficulty here may be that recourse may be had to the experiences of other cultures which may not necessarily fit with the new host environment. As an example, in some countries, national charts of accounts are used on either a mandatory or voluntary basis and are useful for providing data that have been classified and recorded in a uniform manner and for minimizing accounting staff training needs. In other countries, national charts of accounts do not exist, and there is considerable room for flexibility in accounting applications. The introduction of choice as to accounting-information system design into a country that has traditionally required nation-wide use of certain charts of accounts introduces ambiguities which the existing accounting and auditing personnel may find difficult to cope with. Under a national system, for example, the accountant can justify the way a transaction is recorded, by reference to the accounting manual, to the fiscal authorities or other outside auditors. The fiscal and other outside auditors are expert in the national system. Training can be centralized and concentrated on matters related to changes in the external environment, rather than to changes resulting from differences between system designs. So, cultural characteristics need consideration and evaluation.

Changing the legal structure

72. Accounting issues start to multiply when the business interest to be privatized will change its legal structure, as in the case of the current split-off of telecommunication activities from the postal services in France. These two sets of revenue-producing activities were combined in the structure of a government department, following governmental accounting principles. Segregating the two, and establishing commercial accounts for telecommunications within the framework of the French chart, have been both time-consuming and costly involving some 50 employees of an international accounting firm. Under such circumstances, there will be difficulties with respect to the use of historical accounting data for various reasons. First, there has been a shift in accounting theory and practice from a cash-based, public service orientation to that of an accrual-based commercial one. This affects both content and timing of financial statement information. Further, there are problems concerning recorded data, in that, arbitrary allocations of intermingled transactions are necessary in the disentangling process. So, certain historical data may not be available, or various assumptions may have to be made about past transactions for decision-making purposes. For countries considering possible privatization, and operating revenue-producing activities under a governmental accounting system, some thought might be given to setting up

enterprise funds for such operations, with accounting systems that follow commercial practices. This might ease the various difficulties of a transition period, for example. It could also prove most helpful if the privatization approach contemplated were contracting out.

73. If the shift in legal form is to a joint venture and if one or more of the joint venturers is from a foreign country, there may be problems of integrating disparate accounting systems at least for management information purposes. The foreign partner will need, if not formal financial statements, at least informal ones that provide an understandable picture of operations. Poland's new accounting law has accommodated this consideration by permitting all economic units to establish accounting systems of their choice, in foreign languages also if permitted by the Ministry of Finance, as long as standardized reporting forms are used for the main financial statements.

74. Significant reporting issues arise when the new legal form is a publicly held company. The company's records have to be audited and a prospectus published. In Poland's case, prior years' results had to be restated because the national accounting system was revised to eliminate certain categories in funds at the beginning of 1989. The financial statements published in the prospectuses followed the required rules of the home countries of the consulting firms which prepared them. As a result, complaints were published in the Polish press to the effect that prospectuses should be made more relevant for investment decision-making by the general public, or at least more understandable. This raises issues about the types of information that should be circulated in connection with privatization where the financial markets are underdeveloped.

75. The need for public audits by independent auditors affects the entire accounting function, since changes have to be introduced into educational curricula and training programmes for accountants, auditors and faculty. Once again, cultural issues have to be considered, particularly in the training of auditors when sharp changes in political and economic orientations take place, as discussed below.

Changing the economic structure

76. There are further dimensions to the accounting implications when a shift in legal structure is related to major shifts in a country's economic organization. Countries in the process of decentralizing the planning function generally have not used accounting systems designed to assess the financial and operational efficiency of State enterprises. Accounting information has been geared to the needs of production and macro-level interests and some statistical data that could be helpful for business valuation purposes but cannot be restated in financial, monetary terms. Setting a discount rate may not be considered feasible if the political environment, business prospects and rates of inflation are hard to gauge - forcing the valuer back to possibly unreliable historical information. Balance sheets have to be scanned with particular care. As mentioned above, it is possible that book values may be distorted by the absence of various assets and liabilities as well as the monetary valuations assigned to others. In developed market economies, for example, attempts will be made to value the intangible asset of goodwill, which incorporates business reputation and customer loyalty when selling a business interest. When previous business relationships were dictated

from above, or motivated by bartering possibilities under conditions of producer-goods scarcity, and consumer demand usually exceeded supply, goodwill assessment in monetary terms may not be feasible.

77. Thinking through the various cultural and implementation issues in designing new accounting-related laws should ease the difficulties of transition in privatization. Introducing change is difficult in the best of circumstances and introducing severe change requires both understanding and sensitivity.

III. CONCLUSION

78. This report has attempted to give a broad overview of some of the issues surrounding the process of privatization. They include the objectives of the Government in initiating the privatization process; special economic, financial and social conditions that influence the selection of privatization methods; financing techniques; and the necessary steps for the programme's successful implementation. These issues set the stage for the specific discussion of the accounting and valuation problems which arise during privatization. Unfortunately, it was not possible given the constraints of time and space to include case studies of some of the countries that have extensive experience with privatization.

79. Case studies would be a valuable compliment to the general discussion of the processes involved and might serve to highlight and clarify the accounting issues, which have been identified in a preliminary manner. In addition, experts of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting, during their discussion, will undoubtedly add to the list of accounting problems described in this report. Since this topic is so vast in terms of material available, and since it is an issue confronting a number of countries, the Group might wish to continue their investigation and discussion. A detailed review of national experiences might put the Group in a better position to arrive at some general recommendations for accounting and reporting which would benefit countries in the process of initiating privatization programmes.

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